

# California's Lessons for Trade and Monetary Integration

## *Gains from Trade and Investment vs. Fiscal Sovereignty*

NAEFA-  
WEAI  
meetings



San Diego  
7/1/06

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# Note on target audience at the IIRA

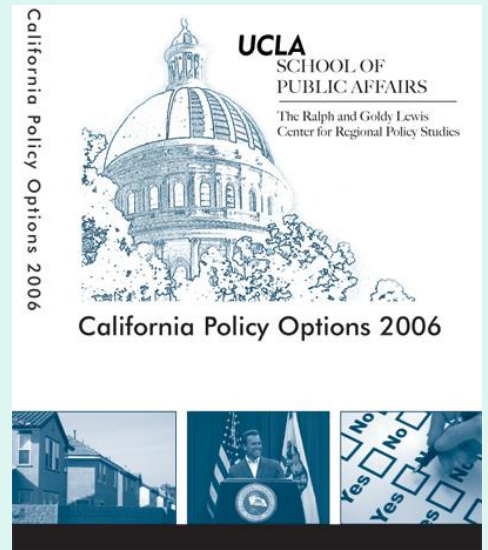
- *Many non-economists or with legal/institutional orientation*
- *Major concerns about “globalism” and its relation to labor standards & social insurance*
- *Issue of dollarization is salient in various Latin American countries and perhaps someday within NAFTA*



Social Actors,  
World Organization  
and New Technologies  
in the 21st Century



# Research background



<http://www.anderson.ucla.edu/x2195.xml>



***California's fiscal  
problems, recently  
and in the past***

**Parallels to countries  
whose monetary policies  
are constrained by  
fixed exchange rates or  
– more significantly – that  
have no local currency.**

# Separate currencies were hallmark of “countries” for most of 20<sup>th</sup> century



Holland



Germany



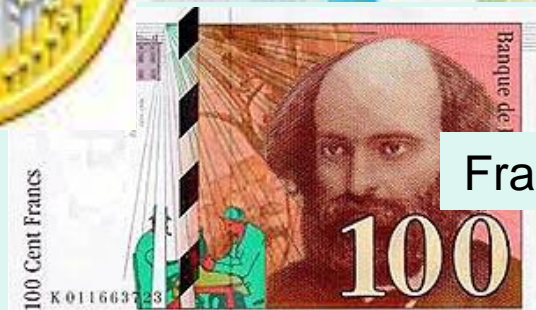
Spain



Italy



Finland



France



Belgium



Ireland



**Separate currencies  
were hallmark of  
“countries” for most of  
20<sup>th</sup> century**

Ecuador



# Comparative advantage or competitive advantage

- **Factor mobility**
  - Capital (financial or equipment)
  - Labor (immigration: legal or illegal)
- **Monetary integration**
- **Although textbooks insist that comparative is the correct model between countries, is the competitive (absolute) approach becoming more relevant than the comparative (relative) approach?**
- **Shift towards absolute**
  - Labor standards & social insurance
  - “Race to the bottom”

**David  
Ricardo  
MP**



vs.



**Michael  
Porter  
PhD**

# Comparative advantage or competitive advantage

- *Financial markets within a currency zone are closer to textbook perfect competition (“law of one price”) than goods markets*
- *Once exchange rate risk is eliminated by monetary integration, local sovereignty is highly constrained*



# Comparative advantage or competitive advantage

- Put another way:
  - *Tariffs and nontariff trade barriers are declining in importance*
  - *Factor mobility is increasing*
  - *Exchange rates are the last barrier holding back loss of national economic sovereignty*





# California becomes a relevant example



# California becomes a relevant example

- Roughly one eighth of US workforce, population, GDP
- If California were a country, it would rank about 6<sup>th</sup> in GDP
  - Ex: California bigger than Canada
- What is a country?
  - Government?
  - Flag?
  - Postage stamps?
  - UN membership?



# International California



# California becomes a relevant example

- Trade integration with rest of US
  - *Barriers to interstate commerce not permitted under US constitution*
  - *Guestimate: California exports to rest of US and world > 60% of its GDP*
- Financial integration with rest of US
  - *Risk adjusted interest rates same in California as in rest of US*
- Part of US “monetary union”
  - *No California dollar*





# California becomes a relevant example

## Financial risk issue

- Dealing with risks to internal banking system and other financial institutions:  
*Potential California issue but handled by federal authorities*
- Dealing with exchange rate (external) risk:  
*Not a California issue*

## Fiscal policy without monetary policy?

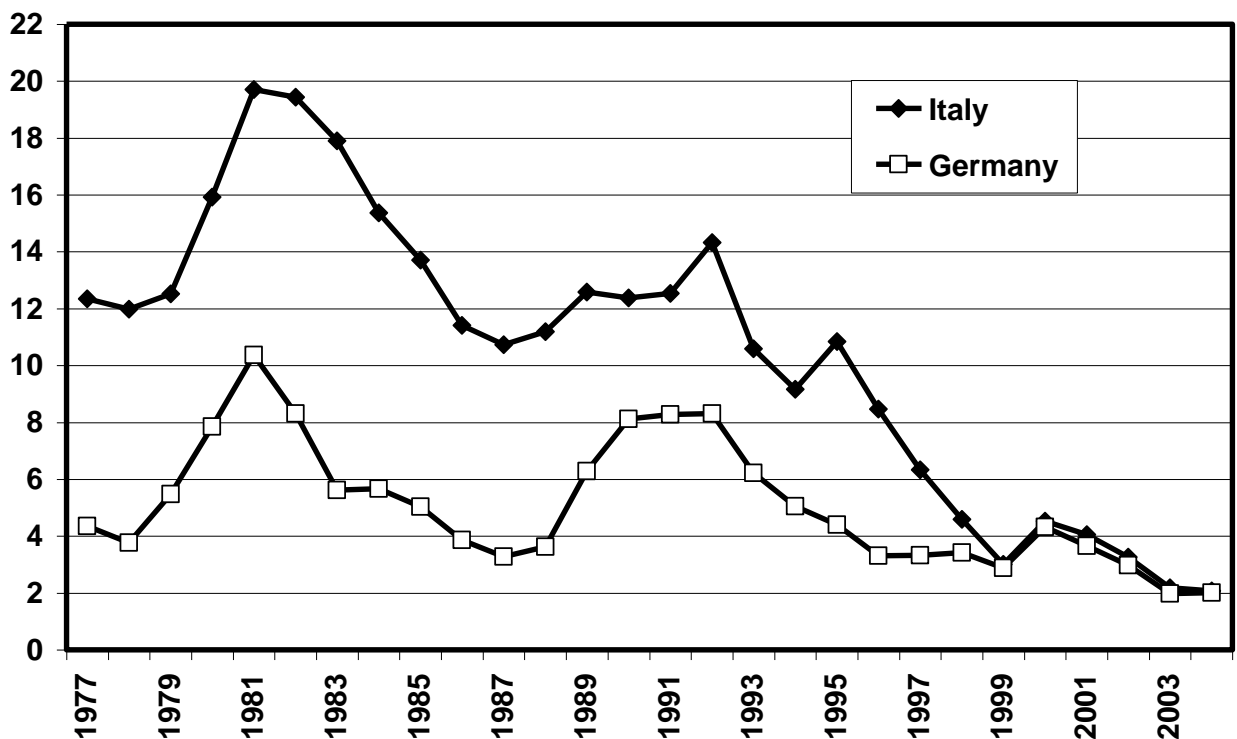
- Financial markets “discipline” fiscal authorities
- California’s government must borrow in a currency it can’t control or create



# Potential gains from monetary integration

- *Reduced transactions costs related to international trade and investment among member nations*
- *Interest rate and inflation rate convergence*

Annual Interest Rates on German and Italian Treasury Bills  
(percent)



**Rejection by France  
(and Holland) of  
Proposed EU  
Constitution through  
“direct democracy”**

- **EU countries have significant social welfare obligations**
  - *Underfunded social insurance*
  - *Aging populations*
  - *Likely future fiscal deficits*
  - *“Social Europe” regulations*
- **Voter recognition that loss of monetary sovereignty will limit fiscal sovereignty?**



## Holland

## France

# Rejection by France (and Holland) of Proposed EU Constitution through “direct democracy”

- EU countries have significant social welfare obligations
  - *Underfunded social insurance*
  - *Aging populations*
  - *Likely future fiscal deficits*
  - *“Social Europe” regulations*
- Voter recognition that loss of monetary sovereignty will limit fiscal sovereignty?
- What do you give up first?

*Wine?*

*Cheese?*

*Central bank?*



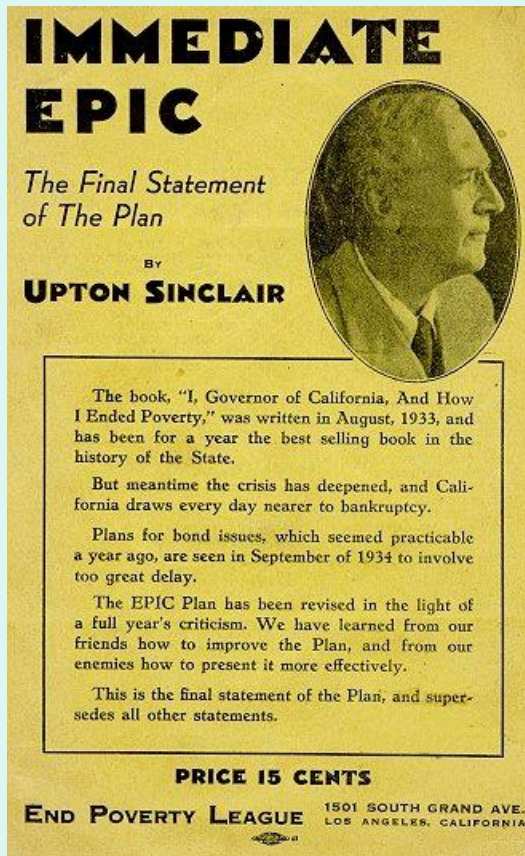


# Lessons from California history



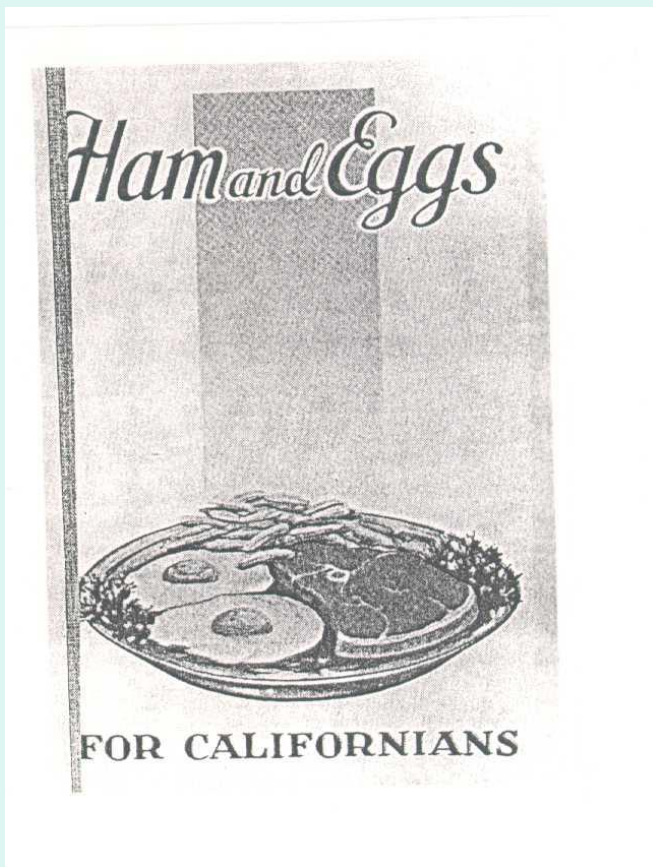
**What happens to an  
economic entity  
without macro  
sovereignty in times of  
economic distress?**

# Lessons from California history



## The Great Depression and the EPIC Plan

# Lessons from California history



**Retirement Warrants**  
**\$30 a Week for Life**

— Means —

BUSINESS PROSPERITY  
LOWER TAXES  
JOBS FOR YOUTH  
SECURITY FOR OLD AGE

*Make It Come True*  
**IT'S UP TO YOU**

## The Great Depression and the Ham & Eggs Plan

# Lessons from California history



**Post-World War II  
prosperity and resources  
but pay-as-you-go  
approach**

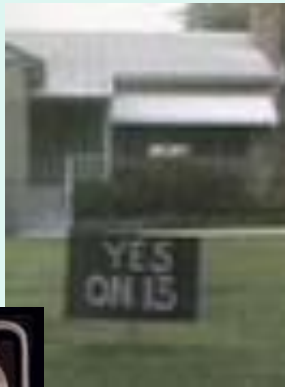


# Lessons from California history



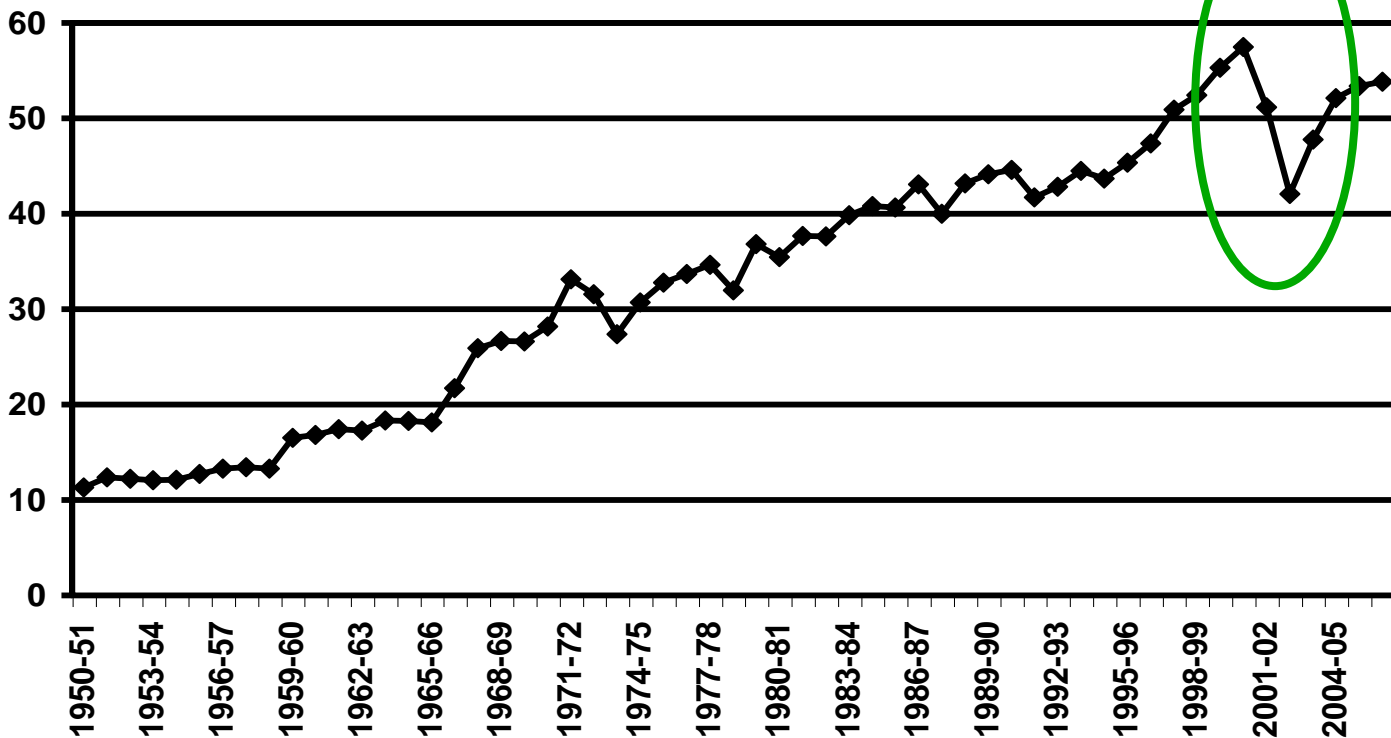
**Increased social spending in the 1960s and Governor Reagan's budget crisis**

***End product was "tax-payer" revolt of 1970s by ballot initiative***



# Lessons from California history

Personal Income Tax as Percent of Total General Fund Revenue



**The fiscal crisis after  
2000 and the 2003  
recall:**

**Fiscal turmoil →  
political turmoil**

# Lessons from California history

- **Surrendering monetary sovereignty diminishes fiscal sovereignty**
  - *Countries should not do the former unless they are prepared to accept the latter*
  - *Implications for countries with substantial social insurance schemes*



# Lessons from California history

- Abolition of local currency ends exchange rate risk, partly insulating private financial sector from being swept into public fiscal crises
  - *California's various state fiscal crises did not affect private financial institutions*
  - *Orange County bankruptcy within California did not affect local private financial institutions in the County*

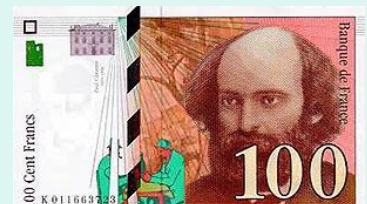
Argentina 2001





# Lessons from California history

- Countries that abolish or tightly peg their currencies will need substantial reserves to protect their financial institutions from internal risks other than those related to exchange rates
  - *Unlike sub-national entities within the US monetary zone, there is no external provider of such reserves automatically available for countries without independent currencies*



# Lessons from California history

- Study of sub-national economies within larger national systems can provide important insights into international economic issues
  - *Studying sub-regional entities may give more insights than the traditional textbook focus on David Ricardo's isolated trading island economies bartering exports and imports*

David  
Ricardo  
MP



vs.



Michael  
Porter  
PhD

# Lessons from California history

- **Study of sub-national economies within larger national systems can provide important insights into international economic issues**
  - *Absent local currency, we move toward “competitiveness” between countries with implications for labor standards. Exchange rates not available to absorb the incidence of alternative national standards.*

David  
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